Detroit Sues Bond Insurer Amid Effort to Reach Deal With Creditors

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Detroit on Friday accused a bond insurer of improperly trying to block access to $170 million in annual tax revenue the city said it needs to shrink its debt with some large creditors.

The lawsuit filed in state court is part of an effort by the city's powerful emergency manager to streamline the process for a potential bankruptcy by cutting as many deals as possible before any court filing, which could come in a matter of months. A filing by Detroit would be the nation's largest municipal bankruptcy.

In the latest move, the city sued Syncora Guarantee Inc., a bond insurer, over access to the city's casino tax revenue, estimated at $170 million a year. The city claims Syncora improperly told a bank controlling the funds to keep the money from Detroit.

The city sees the insurer as a roadblock to a proposed deal to pay UBS AG and Bank of America Merrill Lynch more than 70 cents on the dollar on nearly $340 million in secured debt, according to people familiar with the matter. In exchange, the city would get back $11 million a month in tax revenue from the city's three casinos originally used as collateral to back the debt.

The pending deal would be the first time one of the city's creditors has agreed to new terms since Emergency Manager Kevyn Orr took office in March. Mr. Orr may have a tougher time reaching agreement with the city's unsecured creditors, who he has offered roughly 10 cents on the dollar.

In the middle are insurers like Syncora trying to recoup as much as they can of what the city owes. The insurer is concerned it may have to make up the difference between what the city is willing to pay its secured creditors and the amount originally owed by the city, a person familiar with the matter said.

Syncora also insures other debt associated with the city, another person familiar with the matter said.

A representative for Syncora said in an email Friday that the company had no comment on the litigation.

Wayne County Circuit Judge Jeanne Stempien issued a temporary restraining order saying the casino money could be released to the city and set a hearing for July 26, according to the emergency manager's office.

In 2011, the city had used the casino tax revenue as collateral to secure swap agreements, interest-rate bets the city made with Wall Street banks years ago in the hopes of avoiding higher rates. Detroit's swap agreements are tied to $1.4 billion in bonds the city issued to help address funding shortfalls in its pension funds. In court papers, the city argues that Syncora will not be harmed by the release of the funds because it does not have a right to control them.

Mr. Orr has said Detroit needs significant and fundamental debt relief to shore up the city's finances and avoid bankruptcy. Such relief could include extending the time period for debt repayment, reducing interest rates or cutting the principal owed. The city has already skipped a debt payment of almost $40 million in June, saying it was unsure whether it could continue to make payments on more than $2 billion of secured debt.

The total bill for the city's long-term liabilities is nearly $20 billion, and the city is now insolvent, according to Mr. Orr. Mr. Orr's proposal also calls for using the savings from cutting debt and other city expenses to invest $1.25 billion in public safety and blight removal to revive a city beset by a dwindling tax base, entrenched crime and population loss.

Talks between the city and its creditors will continue next week. Mr. Orr's team will take about 40 representatives of creditors on a bus tour of some of the city's most blighted areas in a effort to demonstrate the severity of the crisis in the city of 700,000.

—Emily Glazer contributed to this article.

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